

To Pierce or Not to Pierce: Findings of Fraud May Make the Difference

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Understanding the alter ego indicators and the implication of fraud on various veil-piercing actions, along with being savvy in the presentation of the relevant facts, circumstances and investigative findings, all serve to answer the question: to pierce or not to pierce.

The corporate “shield” and the protection that it provides are at the foundation of our capitalist society. Without it, investors would be less likely to risk their accumulated assets to new ventures, and entrepreneurship could grind to a halt. The “shield” however should be considered a privilege and when disrespected, it can quickly become porous, making its owners and possibly related third parties vulnerable to the corporation’s obligations. In certain cases, findings of fraud in a corporation by the parties who control it can be the most important element of a veil piercing action.

Today’s economic downturn makes a discussion about piercing the corporate veil timely and relevant. As creditors seek recoveries for unpaid debts, they often find themselves looking into the empty coffers left behind from a failing or insolvent corporation. At the same time, and frustrating to the creditors, the debtor’s owner or other related party entities may be very financially sound. To pierce the corporate veil and thus secure recovery from related parties involves a legal action to declare the debtor corporation and its legal separateness from its owner or related parties null and void, in essence determining the entities

are “alter egos” of one another. Whether evaluating the potential recoveries from filing such a case, actually pursuing such claims or defending against them, one must have thorough understanding of the tests established from prior cases as well as the forensic accounting and financial analysis issues involved in piercing the corporate veil.

NOTABLE CASES

***Berkey v. Third Avenue Railway Co.* 244 N.Y. 84, 155 N.E. 58 (1926)**

Berkey v. Third Avenue Railway Co. is considered to be one of the earliest veil piercing cases adjudicated in 1926 by Judge Benjamin N Cardozo. In this matter, the court ruled in favor of Third Avenue Railway Co. (defendant), the parent company of Forty-Second Street Railway Company who operated a train line on which Minnie Berkey (plaintiff) had an accident. Though the parent company owned practically all of the stock of the subsidiary, and also controlled its Board of Directors, the degree of domination over the subsidiary was deemed inadequate to consider Forty-

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Second Street Railway company an “alter ego” of its parent, Third Avenue Railway Co.

Bud Antle, Inc. v. Eastern Foods, Inc. 758 F.2d 1451 (11th cir. 1985)

In 1985 in the United States Court of Appeals, Eleventh Circuit, Bud Antle sought to recoup debts of its customer B&B Produce Processors (“B&B”), inc. by filing suit against Eastern Foods inc. (“Eastern”), a company which had entered into a management agreement with B&B and an option agreement to purchase all of B&B shares. The two allegations in the case were (1) Eastern had defrauded Bud Antle and (2) A de facto merger had occurred between B&B and Eastern, making Eastern liable for B&B debts. The court granted Eastern’s motion for directed verdict on the fraud count, but allowed the evidence for the de facto merger count to be presented to the jury.

The court’s instructions given to the jury in assessing the existence of a de facto merger gave specific consideration to the existence of fraudulent conduct and fair dealing in the transaction under review. The guidance was stated as follows;

“A company to which assets or property is transferred by whatever means is not ordinarily liable for the debts of the former owner of the assets or property. Some exceptions to this rule obtain when (A) There is an express or implied assumption of liability (B) the transaction is fraudulent, (C) The transfer is not entirely in good faith (D) The company acquiring the assets or property is a mere continuation of the old corporation.”

The jury initially entered a judgment in favor of Bud Antle, but in the Court of Appeals after a careful revisiting of the facts and circumstances including the existence of fraud and an alleged de facto merger (an alter ego indicator discussed further later), the court reversed the judgment and remanded the case.

Perpetual Real Estate Services, Inc. v. Michaelson Properties, Inc. 974 F.2d 545 (4th Cir. 1992)

In 1992, Aaron Michaelson, founder of Michaelson Properties Inc. (“MPI”) was sued by Perpetual

Real Estate Services (“PRES”) to recoup damages that were paid out to purchasers of condominiums built by joint ventures entered into between the two firms.

Michaelson denied any obligation existed for him personally as the obligations were solely the responsibility of MPI, while PRES alleged that MPI was merely an alter-ego of Michaelson. The jury initially ruled in favor of PRES, that the corporate veil should be pierced. Michaelson subsequently appealed. Though there was evidence under the alter ego theory that MPI was merely an agent/instrument of Michaelson, the appellate court found the evidence insufficient to pierce the corporate veil and specifically cited the lack of a fraudulent purpose to the corporation or any of its actions. According to the appellate court’s ruling, “it must also be shown that the corporation was a device or sham used to disguise wrongs, obscure fraud, or conceal crime.” In this case it was determined by the court that the defendant did not use the corporation for fraudulent purposes and therefore the veil piercing attempt failed.

In addition, the appellate court stated that (1) jury instruction failed to communicate element for piercing the corporate veil under Virginia law that shareholder had to use the corporation to “disguise” some legal “wrong” and (2) partner failed to show that shareholder used corporate form to “disguise wrongs,” and thus the corporate veil could not be pierced.

Fletcher v. Atex, Inc. 68F.3d 1451 (2d cir. 1995)

In 1995, in the United States Court of Appeals, Atex and its parent Eastman Kodak were sued for repetitive stress injuries caused by negligent construction of keyboards. In this case the element of fair dealing/fraud, in addition to the standard alter ego tests was once again the key consideration in the alter ego judgment. The Delaware Court discussed the element of fairness and fair dealing in its opinion:

“To prevail on an alter ego claim under Delaware law, a plaintiff must show (1) that the parent and the subsidiary ‘operated as a single economic entity’ and (2) that an ‘overall element of injustice or unfairness...[is] present.’ Among the factors to be considered in determining whether a subsidiary and parent operate as a ‘single economic

entity' are: '[W]hether the corporation was adequately capitalized for the corporate undertaking; whether the corporation was solvent; whether dividends were paid, corporate records kept, officers and directors functioned properly, and other corporate formalities were observed; whether the dominant shareholder siphoned corporate funds; and whether, in general, the corporation functioned as a facade for the dominant shareholder.'"

Under Delaware law, the plaintiff was ultimately not successful in its alter ego arguments, a key reason being that there any were no findings of fraudulent activity to enable a piercing of the corporate veil.

SUMMARY OF ALTER EGO TESTS

In addition to the fraud element mentioned in various instances, the case examples above involved the consideration of four major alter ego indicia, each of which would serve to define the relationship between the entities:

- ***Domination and Control***

- Alter ego is deemed to become most clear when a shareholder or a parent corporation uses its position of influence to favor itself over others. It is generally thought that when facts and circumstances indicate an unfair preference for the parent over less powerful creditors, the courts often seek to protect the third-party creditor.
- Alter ego situations also arise when intercompany transactions are not conducted at arm's length and when certain conditions exist that render the relationship between two companies equivalent to a de facto merger

- ***Financial Dependence***

- A key factor examined under the alter-ego theory is whether the debtor corporation financially depends on the owner. The degree to which the owner capitalizes the debtor corporation so that it can meet its financial obligations as they come due, is a critical component and area of scrutiny when

examining the degree of financial dependence that exists between entities. Both initial capitalization and subsequent capitalization throughout the life of the dependent entity are taken into consideration when examining this indicator.

- Financial dependence is also deemed to exist when owners give the corporation special treatment that they would not give a third party, such as excusing interest payments on inter-company loans or the establishment of lenient (and often undocumented) loan terms.

- ***Confusion about Corporate Identity***

- When parents and subsidiaries have the same name, use the same banks, employ the same officers or make potentially misleading representations, the resulting confusion experienced by the plaintiff would favor a ruling that ultimately pierces the corporate veil.

- ***Lack of Separateness***

- When parents/owners and subsidiaries employ the same directors, officers, use the same offices, engage in the same business activity, contract the same attorneys, the same accountants, utilize the same accounting systems, and fail to conduct intercompany transactions at arm's length, the degree of separateness assessed in a veil piercing action may be adversely affected.
- The courts tend to recognize the corporate veil when there is a high level of compliance though with corporate formalities that may overcome the appearances created by the overlapping relationships above. Commonly assessed corporate formalities include the following:
 - Holding meetings of the board of directors
 - Electing the board of directors annually
 - Holding an annual meeting of shareholders
 - Electing officers annually
 - Enacting and following articles of incorporation and bylaws

As can be seen, there is a fair amount of commonality between the alter ego categories at play in conducting a veil piercing action. In addition, no one factor is controlling and as illustrated in the case examples, the overall assessment is filled with judgment and swayed materially by a determination of unfair dealing and the existence of fraudulent activity.

INVESTIGATING FRAUD IN AN ALTER EGO MATTER

To investigate fraud in an alter ego matter, one should consider three time periods; at the inception of the corporation (although inception is not truly a time period — it's more a point in time), the time period during which the company was at full ordinary operating capacity and the time period during which there was a wind down in operations if applicable.

At the entity's inception, one should probe and challenge the reasons why the entity was created. Of course, incorporating is a lawful exercise, but one should question whether or not there was a conscious intent to remove an activity from a related entity because knowledge of a problem existed or whether or not there was the intention to initiate or acquire an entity which had unusual risks or problems that similarly were hidden from the parties doing business with the new entity. Both examples would require an analysis and comparison of facts and knowledge at the time of establishing the entity to the duties of disclosures and importantly the adequacy of financial independence for the entity when considering such facts.

As to fraud during the operations period, probably the most significant activities to investigate are siphoning of funds, diverting corporate opportunities and other acts which would have impaired the financial stability of the entity to the benefit of a related party.

If a wind down period occurred it may be the period in which fraudulent actions are the most obvious as the entity's inability to continue as a going concern business is likely well known to management and related parties. In fact, the bankruptcy law regarding preferential payments is intended to recover certain transfers during a company's most fragile period. Preferential payments are not fraudulent by nature, but rather are mechanical in time and based on the relationship with the payee. However any nefarious

actions or payments during this critical period may be the most important piece of evidence in an alter ego action to show harm to creditors seeking recovery.

IMPORTANCE OF PRESENTATION

Once the investigation and the analytical phase are complete in an alter ego matter, the presentation phase begins and may be as critical to persuading the trier of fact as the quality of the alter ego tests themselves.

Because the structure and conduct of related party entities generally vary, so will the format of each presentation. That said the following are some are some general suggestions:

- First, an organization chart of related parties is always useful to establish the foundation for the organizational structure of the entities.
- Next, provide a description of each entity's primary business purpose and how funds or transactions flowed in the ordinary course among the entities, if such events occurred.
- It could be critical to then, highlight the unusual actions, flow of funds or transactions among the entities on a separate presentation.
- Consider emphasizing the comparison of expected versus unusual events and transactions via illustration on separate side by side presentations in order to deliver a powerful and appealing message
- Lastly and very importantly, the financial well being of the subject corporation is a key consideration for the analysis, so presenting it both "as is", as well as on a "pro forma" basis with the elimination or normalization of the related parties' conduct can be quite illustrative of harm to the entity and ultimately to the injured parties pursuing the claim.

To conclude, in today's economic downturn, the number of parties who have incurred losses and who will be seeking recoveries and pursuing claims against the related parties of their debtors should be on the rise. The lack of fair dealing and the existence of fraud amongst the entities in question can make

the corporate veil very fragile and in some cases could render the corporate veil non-existent. Understanding the alter ego indicators, and the implication of fraud on various veil-piercing actions, along with

being savvy in the presentation of the relevant facts, circumstances and investigative findings, all serve to answer the question: to pierce or not to pierce.